

# European Contract Law and Economic Welfare: A View from Law and Economics

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### *Abstract*

*The current enterprise of designing and making politically feasible a European Contract Law requires more ambitious goals than just introducing technical improvements in the *acquis* and smoothing the functioning of the internal market. The paper presents a position of the substantive goals of European Contract Law, from an economic approach to legal rules and institutions, linked to the promotion of the joint economic welfare of the contracting parties. In this respect, economic thinking tends to be more sceptical concerning the ability of Contract Law to bring about wealth redistribution policies than most legal scholars are. In the paper, the optimal scope of European Contract Law that is tentatively defended hinges upon inter-firm transactions, although keeping in mind the nature of consumer protection legislation as a regulatory framework to correct the informational market failures in consumer markets.*

### *Summary*

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## 1. Introduction

If one is to judge by the statements contained in the Commission Communication on the action plan for a more coherent Contract Law, the essential goals that should be ascribed to European Contract Law – as the outcome of the existing processes in this area of Law, from various sources and initiatives, and at various levels – is to ensure uniform application of European Community (EC) Law throughout the borders of the Member States, and to ensure the smooth functioning of the internal market in the European Union (EU) area.<sup>1</sup> Even if one factors in the necessary caution not to give rise to suspicions of overextension of the powers of the Commission and the EU generally, it is hard not to be surprised at the absence of broad policy visions in those statements, in terms of the objectives that the emerging European Contract Law can and should achieve.

It seems, thus, not a bit shocking, that several voices have been raised to criticize the bureaucratic flavour and the lack of political ambition of the enterprise – at least if one is not disingenuous about the stated goals – and to propose the use of European Contract Law rules to pursue issues of social justice among individuals and groups in Europe. The Manifesto on Social Justice and European Contract Law is one of the major examples of this critical attitude towards the process and its apparent ends.<sup>2</sup>

In this piece I try to present a position of the substantive goals of European Contract Law from the point of view of the Economic approach to legal rules and institutions. Of course, I do not want to pass as a speaker for the entire scholarly Law and Economics community, which I am not – and which does not exist, by the way – but I will try to present views which I take – may be mistakenly – to be widely shared by those who look at legal systems, and particularly at Contract Law, through the lenses of economic analysis.

I should emphasize that, as stated, I will focus on the substantive goals of material rules of Contract Law, and that I will not deal with the relative advantages or disadvantages, in economic terms, of harmonization versus competition in the field of legal rules on contractual or other market interactions.<sup>3</sup>

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<sup>1</sup> See Communication from the Commission to the European Parliament and the Council, A More Coherent Contract Law. An Action Plan, COM (2003) 68 final.

<sup>2</sup> STUDY GROUP (2004). See also the papers by different authors, mostly resonating ideas present in the Manifesto, in (2006) 2 *European Review of Contract Law* 132 and following.

<sup>3</sup> This should not be interpreted as a judgment on the importance of the matter, only as a result of the recognition of the appeal of the division of labor, given the substantial literature already devoted to this topic: See, among many others, OGUS (1999); ESTY, GERADIN, (2001). My own views, with respect to one of the more important and far-reaching European legal initiatives in market regulation, the Dir 2005/29, see GOMEZ (2006).

I would also like to stress that I do not want to present a middle ground between the two attitudes that I briefly sketched in the opening paragraphs, which could be labelled the internal market rationale and the social justice agenda, both for European Contract Law. I do believe that European Contract Law, apart from the important discussion on constitutional powers and competencies, in order to be a purposive body, needs a clear and coherent set of goals. It is not a mere byproduct of smoothing the functioning of the internal market – albeit it may also serve this goal – but an important part of the legal systems of all European Member States, and perhaps it will be, as such, an important part of the EU legal system as well. I do not share, however, the confidence in this area of the Law to achieve goals of social justice, or redistribution, no matter how commendable the may be as part of a political agenda.

The rest of the paper will be organized as follows. In section 2, I present the role of Contract Law in sustaining cooperation in economic exchange, and the importance of personal, long-term relationships, for the economic theory of Contract Law as opposed to impersonal, spot market interactions. In section 3, I present the goal of promoting well-being, or economic welfare, in broad terms, of the contracting parties, and the reasons why Contract Law is likely to be a less effective redistributive tool than most lawyers, at least academic lawyers, may think. In section 4, I present my, still very tentative, view on how Contract Law should basically be focused on B2B long-term relationships, and how B2C transactions are best handled through adequate regulation of the market failures that may affect those transactions. Section 5 briefly concludes.

## ***2. Market vs. Contract: Contract and Cooperation in Economic Exchange***

One of the basic – if not the most important one – normative questions in modern Economic Theory is how to sustain cooperation in economic exchange. When modern economists use the expression ‘economic exchange’ they are not referring primarily to competitive markets. The reason basically lies in the (at least among economists) success of neoclassical general equilibrium theory. The first fundamental theorem of welfare economics states that if markets are competitive, all individuals are informed, and all commodities are allocated by means of markets, then individual interaction through a complete set of markets produces Pareto efficiency. An outcome or social situation can be characterized as Pareto efficient if no improvement is possible without someone being worse-off, which makes Pareto efficiency a relatively undisputed – impractical, however, in many instances due to its very exacting requirements – criterion, at least among social scientists and philosophers, to determine social desirability.<sup>4</sup>

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<sup>4</sup> See, on legal and other views of the Pareto criterion, and the reasons why its lack of appeal lies in its incomplete coverage of most real life social dilemmas, not on the lack of normative force, ADLER, POSNER (2006).

Of course, economists know that the conditions for the theorem to hold are very strong,<sup>5</sup> and that market imperfections abound in the real world, but still the theoretical and practical relevance of the first fundamental theorem of welfare economics is hard to deny. It implies that when interactions between economic agents can be approximated by the features above stated, the impersonal, spot and short-term exchange through markets ensures that the welfare of each and every participant is maximized, that is, that we can achieve perfect and optimal cooperation from the agents, even if behaving independently and self-interestedly.

In a perfect market interaction, thus, one should not loose time and effort inquiring about the trustworthiness of the other side of the interaction, or whether the terms of exchange might be better round the corner, or whether the other party will fulfil the explicit or implicit promises of the exchange. The fact that it is an interaction in a perfect market makes all these meaningless. The main consequence of this in economic terms is not descriptive, but normative: whenever it is feasible, societies should strive to build markets as comprehensive and well-functioning as possible, because in this way they would improve the economic welfare of all the individuals in the society. And to build and structure well-functioning markets –according to the exacting conditions of Economic Theory- a detailed and sophisticated set of Contract Law rules is largely superfluous.

From the legal system, markets in this sense of perfectly competitive ones mostly need basic constitutional rules on private property rights, personal liberty, freedom of enterprise, and the rule of law, general rules of criminal and private (in Contract and in Tort) law against the use of force, duress and fraud in personal and economic exchange, and non-consented harm and, increasingly, a set of antitrust rules that guarantee the competitive structure of markets that rely on those fundamental background legal rules. A complete set of Contract Law rules to govern (at least as default or non-mandatory rules) those market interactions (in the strong technical sense of the term) would not significantly affect the performance of those markets.

One could think of those Contract Law rules as useful tools for the correction of market failures (in the competitiveness of supply, in the symmetry of information and so on), but even in this respect, one must remember that when economic theory speaks of perfect markets in the true sense, it is thinking of broad, impersonal frames of exchange, not the individual relationships, with a specific buyer and a specific seller which Contract Law rules traditionally refer to.<sup>6</sup> Thus, the remedies to

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<sup>5</sup> For instance, the assumptions in economic theory for a perfectly competitive market are the following: Atomicity of producers (the number of producers is so large that no single producer has an impact on what others do); product homogeneity (the products by all different producers are perfect substitutes); perfect information (both producers and consumers have perfect knowledge of all relevant variables); equality of producers (all producers have the same technology and cost functions); free and unlimited entry (any producer may enter or exit the market as it wishes). Of course, this set of assumptions clearly shows that perfect competition is a theoretical construct, and that it is not something that we can derive by induction or observation from real-world markets.

<sup>6</sup> Throughout the paper I will use the terms buyer and seller to mean the parties to a contractual relationship, no matter the nature of the contractual matter or behaviors involved.

market failures, whenever necessary to reasonably approximate the real world performance of a market to the essential features of a perfectly competitive one, cannot work piecemeal, within the specifics of a particular contract. They have to be general and structural, given that markets also possess those features as frameworks for economic cooperation and exchange.

The preceding ideas should not lead us to think that Contract Law has a limited or unimportant role to play according to modern Economic Theory. This may be true for perfect – or nearly so – markets. But these do not cover the entire realm of desirable economic cooperation, quite the opposite. Modern economists think that the most interesting economic exchanges do not take place in perfect markets, but in imperfect markets, or in situations in which markets are only of little relevance. Contrary to intuition, this is the case, for instance, of the relationship between an employer and an employee, or a wholesaler and a retailer, or a seller of a good of uncertain quality and a buyer. In fact, modern economists tend to focus on human interactions outside perfect markets.

Thus, the basic question of modern Economic theory can be reformulated as follows: Outside perfectly – or approximately so – functioning markets, what are the means to induce the adoption of cooperative actions in human relations, countering the impulse present in individuals to behave opportunistically and to pursue self-interest at the expense of the common welfare of all interacting parties?<sup>7</sup>

This is where Contract Law reappears with force. The set of issues behind this question, and the set of responses to it, are of particular interest to Private Law, and Contract Law more specifically, being it the most ostensible area of the Law directed to promote and protect cooperation and exchange between individuals and firms. This interest should be particularly acute when the task (at the National, European, or International levels) is precisely to design legal rules and institutions that promote cooperative behaviour and, in the end, social welfare through desirable interactions by members of the relevant groups or societies. The centrality of the notion of cooperation in non-perfect market interactions (contractual interactions, in economic terms) does not imply, however, that Contract Law is necessarily the most important, let alone the sole force able to generate the positive level of cooperation among different individuals that will allow societies to prosper. It is this setting of imperfect market interaction in which the importance of institutions, legal institutions paramount among them, to reduce uncertainty and transaction costs in exchange has proven crucial for economic and social development, as the most illustrious economic historians have highlighted.<sup>8</sup>

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<sup>7</sup> The fact that modern economic theory does not focus on perfect markets does not imply that the basic toolkit of economics (rationality, consistent utility functions, maximization of preferences, equilibrium) have been abandoned to explore the setting of the economic interactions that take place outside the realm of perfect markets. They have simply been redirected to a new object of interest.

<sup>8</sup> NORTH (2005, p. 116 and following).

Importance and relevance do not imply uniqueness, and even less, do not imply costlessness. As I shall present in a moment, economists tend to relegate the Law in general, and Contract Law in particular, to the last instance, not because they think it is the least important or theoretically attractive (quite the opposite) but because it is a particularly costly mechanism in social terms (the Law and legal enforcement entail substantial costs, both to the parties and to society in general).

## 2.1. Basic instruments to achieve cooperation

Economists, and social scientists more generally, have identified different mechanisms to achieve cooperation among humans.<sup>9</sup> It has to be noted, however, that some of them are not exclusive to humans, but to some extent are shared by humans and animals.

### a. Biological kin selection

Biological selection favours genes with higher survival and reproductive payoffs, and reproductive success involves not just selfish behaviour, but also cooperative, disinterested behaviour, if this benefits other individuals sharing a part of the relevant genes. This explains why in the animal and the human world, cooperation between family members seems prevalent.

### b. Selfish cooperation

Some human interactions are characterized by a structure of payoffs to participating parties by which it is in the self-interest of each participating party to take the action that is jointly preferable (ie conducive to the common good) if and only if the rest of the interacting parties do likewise. In the terminology of game theory, these interactions are called (for reasons unknown to me) as assurance games. Here is an example of an assurance game:

		Player 2	
		Cooperate	Defect
Player 1	Cooperate	4, 4	0, 3
	Defect	3, 0	2, 2

Figure 1

<sup>9</sup> DIXIT (2004).

As you can observe, in assurance games there is more than a single Nash equilibrium. Although (Cooperate, Cooperate) is the pareto-optimal (ie preferred by both players) outcome, it is not the only equilibrium. (Defect, Defect) is also a Nash equilibrium,<sup>10</sup> because no player has an incentive to deviate if the other does not deviate.

There are several ways to select a specific equilibrium, in particular, to select the pareto-optimal equilibrium. A formal and legally enforceable contract imposing legal obligations on both parties to execute the actions corresponding to the desired equilibrium (Cooperate, Cooperate) is one option, though it may not be workable in many settings of human interaction.

Creating common expectations on the resulting equilibrium might do the trick, with less expense, and less institutional apparatus, than formal contracting: If each player is convinced that the other will cooperate, and each is convinced that the other is equally convinced of it, they will both choose to cooperate, and thus the pareto-optimal equilibrium will be achieved. There are several mechanisms to coordinate expectations to obtain cooperation in this sense.

Typically, long-term relationships can serve to effectively coordinate expectations of behaviour by all involved parties, and therefore, to induce the desired cooperation for the common good, or maximization of overall social welfare.

The Law, in an expressive function, can serve also to coordinate expectations around a focal point. The fact that a given conduct (Defect, in our example) is labelled as illegal, or as less desirable by the legal system, makes the other option the focal point to coordinate the expectations on behaviour by the parties.<sup>11</sup> But this coordination effect of the Law is not restricted to contract Law, nor to the legal regulation of long-term contracts.

### **c. Altruism (or fairness)**

Interacting agents might not only have self-regarding preferences, but other-regarding preferences as well, based on altruism or similar notions (preference for cooperativeness, or for achieving the common good of the parties as such, independently of how the individual acting will fare under such an outcome). Although the educational function of the Law, or of Contract Law more specifically, cannot be completely disregarded in fostering this kind of preferences, it is arguable that it is not a forceful factor in the promotion of collective altruism or cooperativeness as a preference. It should be noted that I am not denying the general importance of such tastes or preferences, nor the

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<sup>10</sup> Nash equilibrium (named after its discoverer, J. NASH, the famous mathematician and recipient of the Nobel Prize in Economics in 1994) is an equilibrium concept in Game Theory that selects from the strategy space of the interacting players those from which one player, acting on his own, has no incentive to deviate, provided that the other player does not deviate from the chosen course of action.

<sup>11</sup> See MCADAMS (2000, pp. 1649-1729).



empirical degree of their prevalence among individuals generally, or in particular subsets of the general population. I am also expressing doubts on the existence of evidence regarding the fact that Contract Law rules do actually serve in a significant way to instil preferences for altruism, or cooperation for its own sake, even when this contradicts the self-regarding preferences of the contracting party, and also that Contract Law can take a preference such as an other-regarding preference as granted.<sup>12</sup> I am unaware of evidence in this respect, even if one accepts without questioning the experimental evidence provided by psychologists and experimental economists concerning the possible existence of a taste for fairness:<sup>13</sup> This evidence may document a human preference for being treated fairly and not dismissively (as for instance, being offered a trivial amount in an ultimatum game) but does not extend to a general altruistic preference *per se* in contractual exchanges.

#### d. Reciprocity in contractual relationships

Probably the most famous application of game theory outside economics is the prisoners' dilemma. The prisoners' dilemma is a strategic structure (albeit not the only one) that characterizes many interactions involving cooperation between two parties.

In a one shot interaction, the prisoners' dilemma structure cannot sustain cooperation by the players, to the detriment of the interests of each and both of them: Each player has a dominant strategy of defecting from cooperation.

		Player 2	
		Cooperate	Defect
Player 1	Cooperate	4, 4	0, 5
	Defect	5, 0	1, 1

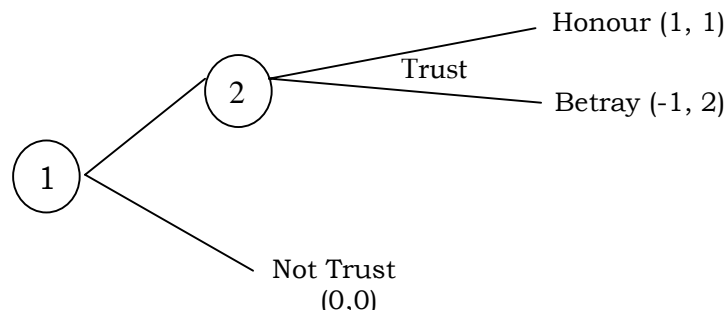
Figure 2

<sup>12</sup> This does not imply espousing generally a holmesian bad-man-theory of Contract Law, simply questioning an assumption of general altruism in Contract Law. The bad-man-theory of legal thinking, and the strict separation from moral thinking, in HOLMES JR.(1987, p. 497).

<sup>13</sup> See C. CAMERER (2003, p. 43 and following) for an extensive review of the experimental evidence on ultimatum and dictator games. In the end, the evidence seems more supportive of an inequality-aversion (or 'envy and guilt') taste more than of a general altruistic preference: CAMERER (2003, p. 102 and following).

If the interaction is a unique, or one-shot interaction, the unique strictly dominant strategy equilibrium is (Defect, Defect), producing pay-offs for the parties of (1, 1), which are strictly dominated in the Pareto sense by (4, 4).

This dismal result is not a feature of the fact that both players choose their actions simultaneously. Even if one acts after the other and is thus able to observe the other party's move, the non-cooperation outcome still holds. This is the case of the one-shot dynamic interaction, such as the so-called trust game:<sup>14</sup> Here, not trust and betray are non-cooperative actions, whereas trust and honour are the cooperative actions.



**Figure 3**

The game begins with a decision node for Player 1, who can choose either to Trust or Not Trust Player 2. If player 1 chooses Trust, then the game reaches a stage in which Player 2 can choose either to Honour or Betray Player 1's Trust. If Player 1 chooses Not Trust, then the game ends (in fact, Player 1 chooses not to initiate a relationship).

If Player 1 chooses not to establish a relationship, both players' payoffs are zero. If Player 1 chooses to trust Player 2, however, then both players' payoffs are one if Player 2 honours 1's trust, but Player 1 receives -1 and Player 2 receives a pay-off of two if Player 2 betrays Player 1's trust.

The Trust Game can be easily solved by backwards induction or rollback – that is, by working backwards through the game tree, one node at a time.

If player 2 gets to move (ie if Player 1 has chosen Trust) then Player 2 can receive either a payoff of one by honouring Player 1's trust, or a payoff of two by betraying Player 1's trust. Since two exceeds one, Player 2 will betray Player 1's trust if given the opportunity to do so. Knowing this, Player 1's initial choice amounts to either not initiating the relationship (and so receiving a payoff of zero) or trusting Player 2 (and so receiving a payoff of -1, after Player 2 betrays Player 1's trust). Since zero exceeds -1, Player 1 rationally prefers not to create the relationship, contractual or of other kind.

<sup>14</sup> KREPS (1990).

Therefore, in a dynamic setting, cooperation in exchange cannot be sustained, even if both parties would be better off by trusting and honouring trust, by establishing and respecting the relationship.

Things may be different in repeated interactions, however, and hence the great importance of long-term relationships to sustain cooperation in economic exchange. But simple repetition of the game is not enough. The economic idea of a long-term relationship goes beyond the mere repetition of a one-shot game. The argument is as follows:

Assume that the trust game is played in exactly the same terms as shown above, with the difference that it is played a very large number of periods,  $T$ . Let's think first, using again the perspective of backwards induction, of the last period. In the  $T$ th period, Player 2 has no reason to honour the relationship, because he can obtain a higher pay-off by betraying than by honouring, given there is no future to care about in this last period. Anticipating this, Player 1 will not enter the relationship in the last period,  $T$ . Then, the last possible effective period of the relationship is the  $T-1$ th period. Here, Player 2 knows it is the last period, and therefore he would behave accordingly, betraying Player's 1 trust. Anticipating this, Player 1 will not play the  $T-1$ th round, making the  $T-2$ th the last plausible period. And so the dismal logic of the trust game unravels down to period 1, and both players find themselves exactly in the same position as in the one-shot interaction. Finite repetition does not improve cooperation in economic exchange. Cooperation remains unachievable when the parties know their relationship will last for a fixed and known length of time.<sup>15</sup>

But the trust game (or other games involving cooperation, such as the prisoners' dilemma) can be repeated an infinite number of periods or, more realistically, that it can be played an unknown – by the parties – number of periods, so the interaction can end at any round, with a given probability which the parties are unable to control.

In such a scenario, it is possible to show that if the parties care enough about the future (ie the discount factor at which they discount pay-offs ahead in the future is not too large), reciprocity strategies in the repeated interaction can lead to cooperative outcomes.<sup>16 17</sup> The two reciprocity strategies most used in the game-theoretic literature are the following: The grim-trigger strategy, which states for each player: Choose a cooperative action until the other player deviates from cooperation; once the other player has defected, play defect forever after. Or, alternatively, the Tit-

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<sup>15</sup> This result is known in game theory as the chain-store paradox, and was demonstrated by R. SELTEN (also a recipient of the Nobel Prize in Economics in 1994) in his theorem on unique subgame-perfect equilibria.

<sup>16</sup> Although many economists use terms such as trust, or reputation, in fact they refer mostly to something that is best captured by the term reciprocity. For instance, an infinitely repeated interaction, such as the one described in the text, is equivalent to one-shot two-players interactions among all members in a given society, where each player is perfectly informed about the reputation (the past history of cooperation or defection), of each and every other player. This shows that reputation is in fact nothing different from reciprocation in conceptual terms.

<sup>17</sup> See WATSON (2002); GIBBONS (2001).

for-tat strategy, which states for each player: Choose a cooperative action if the other player cooperated in the previous period; defect if the other player defected in the previous round.

This powerful result that reciprocity can achieve cooperation has been crucial to the relevance of contracts in recent Economic Theory. Even in the absence of other external mechanisms to achieve cooperation in economic exchange, most notably, even in the absence of complete, formal, and legally enforceable contracts, in long-term relationships, the parties themselves can attain satisfactory cooperative outcomes.

If parties can write complete contracts specifying the pareto-optimal actions, and Courts can costlessly enforce them, of course, the short or long nature of the relationship, and the use or not of reciprocity strategies, is of no importance: Contract Law can force cooperation through the use of the appropriate legal sanction. This is why economists, when approaching contractual relationships of some duration, have routinely assumed that contracts between the parties are incomplete, that is, they do not specify the complete set of optimal actions by the contractual parties. This makes the contract a relational contract: Many of the relevant actions cannot be foreseen and specified when the contract is signed, and it is in the course of the ongoing relationship that the parties will adopt those actions, based upon the set of incentives arising from factors (personal, institutional) different from the formal contract and the legal rules in contract Law. The contract can be based on information that cannot be verified by a Court of Law, or controlled by formal legal rules and procedures. The relational contract can be based on information only at the disposal of the parties as it becomes available, maybe only as a result of a change of circumstances.

Of course, a contract in this sense cannot be enforced by a Court or an arbiter. The quest in contracts with future contingencies is, thus, the design of self-enforcing contracts, those in which the parties are induced to adopt the best available actions for the common good, based on their own strategies, but checked by reciprocity, reputation, or other intrinsic motivators. The power of reputation as a motor of cooperative behaviour depends upon a diverse set of factors: the temporal horizon of future interaction, the number and importance of future interactions, the likelihood that opportunistic behaviour will become known to future contracting parties, the size and closeness of the relative sectors or communities, the existence of implicit reputational bonds, such as advertising expenditure, and so on.

For instance, it is reputation the factor that has been advanced by some economic commentators to explain the persistent presence of one-sided (favouring the firm) standard terms in contracts between large firms and consumers. They are not the result of asymmetric bargaining power, or inadequate consumer information, but merely a necessary check on opportunism by consumer, who do not care about their reputation when dealing with a firm – it is unlikely that the opportunistic behaviour will become known to other firms –, whereas firms, who are constrained by their concern for living up to

their reputation, are unlikely to exploit the contract term that – nominally – is twisted in its favour.<sup>18</sup> Whatever the value of this particular application, the key lesson is that reputations matter, and much, to the incentives for desirable behaviour in the kind of relationships that Contract Law typically and most centrally govern.

#### **e. External enforcement mechanisms (notably Contract Law)**

It is clear that society as a whole benefits from the fact that its members behave mostly in a cooperative way – in the interest of joint welfare of the parties – when they interact in different settings. This explains why societies have developed systems to enforce cooperative commitments by individuals.

These enforcement systems may show a variable degree of formalization and State intervention. For instance, take the trust game in figure 3. If we change from 2 to -1 the pay-off of Player 2 in case of betrayal, to reflect social disapproval by third parties of the non-cooperative behaviour of that Player, then (Trust, Honour) becomes the only Nash equilibrium of the game. Social disapproval may be expressed by a social sanction in the form of ostracism, negative gossip, etc. Many economic exchanges have taken place historically (and even nowadays) within relatively closed social groups defined by ethnic origin, religious affiliation, or philosophical creed, and in those contexts social sanctions are particularly powerful motivators towards cooperation.<sup>19</sup>

It cannot be denied that in large and open societies the most powerful external mechanism to promote cooperation in economic exchange is the legal system. To operate as an enforcement instrument, legal systems require a set of rules determining cooperative behaviour in a given context, an external (to the parties involved) authority to enforce the rules, and a system to produce the relevant information in order to apply the rule of cooperation in a given situation.

When individuals can write a complete contract that determines contractual behaviour in the whole set of possible circumstances, and the basis of each contractual determination can be verified by the legal enforcer, typically, a Court of Law, the role of the legal system in the economists' eyes is essentially mechanistic: the role of the Law would substantially be equivalent to blind enforcement of each and every term in the complete contract set out by the parties.

But complete contracts are not only, as described above, less interesting from a theoretical point of view when dealing contractual relationships outside perfect markets. They are also the rule in the real world, given the extremely exacting requirements that pareto-optimality, completeness of coverage, and verifiability of information pose on complete contracts. A number of reasons have been identified by economic theorists supporting the proposition that contractual incompleteness

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<sup>18</sup> See L. BEBCHUK, R. POSNER (2006).

<sup>19</sup> See, for historical examples, A. GREIF (1994).

(and thus the preponderance of relational contracts) is the rule and not the exception: The prevalence of non-verifiable information concerning many relevant contractual behaviours; the inevitability of imperfect specification of actions that will take place in the future, and in all possible states of the world in the future; difficulties in measuring and evaluating the cooperativeness of contractual behaviours, given the multidimensionality of complexity of many of them; advantage, under certain circumstances, of internal (including reciprocity-based) motivators for cooperation over external mechanisms such as formal and legally enforceable contracts.<sup>20</sup>

A crucial issue remains thus open concerning the role of Law and formal, enforceable contracts, specially in long-term relationships. Does the use of contract Law promote or undermine cooperation in interactions that are not on the spot exchanges, but take place in stable, prolonged, even long-term contact? The response from economic theorists is – to lawyers, at least – surprisingly mixed and cautious. Although the Law, and Contract Law in particular, is a powerful instrument to create incentives for cooperative behaviour in economic exchange, it is not certain whether contract Law generally improve or weaken the self-enforcing nature of relational contracts. Two factors weigh in opposite directions. First, in a positive way, contract Law reduces the likelihood of breaching a contract, by making non-cooperative behaviour more costly and/or the gains from opportunistic behaviour less important. In the latter, unwelcome direction, it can be said that contract Law may reduce the effectiveness of the other self-enforcing mechanisms in contracts, thus reducing the costs of non-cooperative behaviour.

As a consequence, it has to be acknowledged that the big questions concerning the actual effects of Contract Law on contractual relationships (typically, long-term relationships in which time matters, and future contingencies for which the agreement of the parties cannot provide a solution specified in advance) remain largely unanswered by economic theory in a fully convincing way. It is also true, though, that from an economist's perspective, the role of Contract Law cannot be properly understood without a joint contemplation of (at least) the legal factors, and of the 'internal' or self-enforcing dimensions in long-term relationships.

The preceding statement, however, with respect to the role of Contract Law to foster economic cooperation outside perfectly competitive markets mostly concerns the 'how' and not the 'whether', that is, introduces a note of caution as the content of the substantive legal rules governing contractual relationships: Legal rules and institutions in isolation do not capture the full picture of cooperation in contracts. An exclusive focus on the legal dimensions might induce a design of rules and legal instruments that interfere with non-legal mechanisms promoting desirable cooperative outcomes, with the undesired result that some substantive Contract Law rules may actually end up reducing, rather than increasing, the level of cooperation in economic exchange.

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<sup>20</sup> See M. BROWN, A. FALK, E. FEHR (2002), for experiments showing how explicit and enforceable contractual clauses may crowd out reciprocity and altruism in contracting. The best synthesis of available experimental evidence on these issues is CAMERER (2003).

### *3. Economic Welfare and Contract Law: Efficiency and Distribution*

The long discussion in the preceding section has led the way to the design of substantive rules of Contract Law in order to induce cooperation in those instances of interaction among economic agents (individuals and firms) that take place outside well-performing and structured markets – in perfect markets. The recipe from Economic Theory is simple at the abstract level, corresponding to the abstract goal of Contract Law as seen economically. Contract Law rules should be crafted as to create the incentives for the behaviour of the contracting partners that would maximize the welfare of the parties affected by the contract or, in more precise economic jargon, to maximize the joint surplus from the contractual relationship.

From the perspective of normative reasoning, Economics (and Law and Economics, which essentially is applied welfare Economics in the fields touched upon by, or that concern, the Law), as a social science, is consequentialist and welfarist in its approach to societal problems. Welfarism in this regard allows degrees, and some may advocate a strict version of welfarism, which condemns, in social decision-making, any consideration that is not embodied in the well-being or welfare of individuals.<sup>21</sup> Others adopt a milder or weaker version of welfarism, which notwithstanding a strong weight attached to the individual welfare, does not rule out other social values, which may not demonstrably have entered the well-being of an identifiable individual.<sup>22</sup> Although the differences between strict and mild welfarism are significant from a theoretical viewpoint, I don't think that the issue can be resolved inside economic analysis (or Law and Economics) by itself, and, more importantly, my view is that those differences have little bearing on issues of Contract Law (they are more relevant in Criminal or Constitutional Law), so I will not pursue this distinction much further.

Both versions of welfarism in economic analysis (including economic analysis of Law) coincide in their individualistic (or autonomy-based, or libertarian, if one prefers) approach to individual welfare. Preferences held by an individual are taken essentially as given, and a matter of individual choice, genetic predisposition or determination, or cultural influence, or peer pressure, but mainly outside the bounds of the judgment of the analyst. It is true that economists are devoting increasing attention to the process of preference formation (in which the Law may play a role, undoubtedly). In fact, social norms have received in recent years a substantial degree of curiosity and analysis by

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<sup>21</sup> See KAPLOW, SHAVELL (2002, chapter 1). A strict welfarist would not allow restrictions on what individuals consider as welfare-enhancing, based on moral or other factors external to the individual himself. A strict welfarist would not accord any value at all to those other factors in a social welfare function.

<sup>22</sup> See Adler, POSNER (2006). A mild welfarist may allow restrictions on what individuals judge as their welfare or well-being, based on ethical or other criteria, as well as credit some weight to those other factors in the social welfare function.

economists and economically-oriented lawyers.<sup>23</sup> But still the core of this literature has remained positive in analytical terms, and the results have not entered the mainstream of economic normative reasoning.

Contrary to commonly accepted wisdom among philosophers and legal scholars critical of the economic approach to social and legal decision-making, welfarism, either in the strict or in the milder form, does not entail a rejection of distributive goals. Distribution might enter the welfarist picture dominant in Economics and in Law and Economics through three different avenues.

First, individuals in society may have preferences concerning fair or just distribution of resources, and therefore their well-being will be affected by how different options in social decision influence these distributive issues. The impact of distribution is, however, indirect, through particular – how idiosyncratic will they be, is a different, and solvable only through empirical inquiry, matter – tastes or preferences actually present in the individual utility functions composing the social welfare aggregate.

Second, well-being depends on the level of wealth (meaning all material resources available to the individual), and thus the distribution of wealth affects individual and, consequently, overall social welfare. It seems a very plausible generalization about individual human welfare that wealth increases the utility (the traditional term in economics to name individual well-being) of the individual, albeit at a diminishing rate, that is, that each additional unit of wealth adds less utility to the total than the preceding units. This generalization is commonly known as decreasing marginal utility of wealth. For some, it may have important – both at a theoretical and at a policy level – distributive consequences. If one thinks that interpersonal comparisons of welfare are possible,<sup>24</sup> decreasing marginal utility of wealth implies that if we compare two social situations that add an additional unit of wealth, one to a rich individual and the second to a poor one, the second is preferable in terms of aggregate social welfare, because it adds more welfare than the first. It can, thus, justify, extensive redistribution from the better-off in favour of the worse-off.

Moreover, this redistributive bent is increased under most (non-additive) systems of aggregating the welfare of each and every individual into a social welfare function. For instance, if individual well-beings of the members of the relevant population are aggregated not through mere summation, but by other operators (multiplicative, exponential, etc) distribution of welfare within the population is relevant for overall social welfare.

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<sup>23</sup> See POSNER (2001).

<sup>24</sup> At the theoretical level, interpersonal comparisons of utility were taboo for neoclassical economic analysis (ROBBINS (1932) is the canonical exposition of such negative attitude), but nowadays some ways to circumvent the taboo have successfully been explored in the literature: See ADLER, POSNER (2006, chapter 3), for an excellent reference to these issues, with an eye towards legal applications.



Third, levels of wealth of an individual can directly affect incentives to behave in different areas subject to legal rules. One of the clearest instances refers to the assets of the agents engaging in activities that can cause harm to others. If an individual or a firm has limited assets, so that he may be unable to pay for all resulting harm arising from his activity, his incentives to take care under alternative liability rules are distorted, and he will take less precaution than that required by social optimality.<sup>25</sup> It can be shown that adapting (lowering) safety standards to the levels of assets of the potential injurer, actually improves the incentives to take safety measures, and in fact, with an adequately chosen more adaptive and softer standard, the legal system can maximize the precautionary effort of potential injurers, thus attaining a second-best situation.<sup>26</sup> This means that in the presence of exogenously given and limited levels of assets,<sup>27</sup> poorer potential injurers should optimally be subject to lower standards of behaviour than richer individuals, and this result does not depend neither on a taste for redistribution, nor on interpersonal comparisons of well-being. It is based on a pure incentive (or efficiency, if one prefers to word it this way) effect, which is nevertheless dependent on the level and the distribution of wealth. In fact, when determining optimal standards for an entire population, the level of wealth, but also its distribution, are crucial factors for determining the desirable safety standards, and it can be shown that under certain regularity conditions of the distribution of assets, the wealthier a given society becomes, the higher the relevant standards should be.<sup>28</sup>

The initial economic position on the guiding principle for the design of the substantive content of Contract Law rules is that the Law should create (taking in due regard the non-legal sources or incentives for cooperation within the relationship) the incentives for the behaviour of the contracting partners that would maximize their welfare of the parties affected by the contract or, in more precise economic jargon, to maximize the joint surplus from the contractual relationship. Of course, this assumes that the contract does not affect third-parties, because when this assumption is not satisfied, a pure welfarist treatment of the contract should include also the impact of the contract on the welfare of the non-contracting but affected parties. Thus, even if two firms are made better-off by a collusive agreement that restricts competition, there are good reasons for the Law – and for Contract Law – not to enforce such an agreement and, on the contrary, not to give effect to the parties' intentions and to subject it to sanctions, even criminal ones. The same happens to an agreement that intends or helps to perform an intrinsically illegal action, such as murder, theft, or kidnapping. In fact, Contract Law rules consider those agreements void, and, from an economic perspective, rightfully so, due to the important negative external effects arising from them.

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<sup>25</sup> This effect of limited assets (known as the judgment-proof problem) was first formally and generally established by SHAVELL (1986, pp. 43-58).

<sup>26</sup> GANUZA, GOMEZ (2006a).

<sup>27</sup> When the levels of assets are endogenous, if the standard is nevertheless designed and imposed generally, the main result still holds: GANUZA, GOMEZ (2006b).

<sup>28</sup> And this result does not depend on the dependence of the level of harm on the level of assets in the population, that is, it applies as well to a wealth-independent (environmental, for instance) external harm: GANUZA, GOMEZ (2006a).

Contract Law of different Member States, moreover, sometimes contain rules ancillary to the nullity principle that try to create negative contract incentives (ie disincentives) to engage in such agreements.<sup>29</sup> In fact, such rules typically try to erode the incentives for cooperation within those agreements, and to create incentives for opportunistic behaviour, thus discouraging the potential contracting parties from entering into them.

The bulk of Contract Law rules, and also in present European Contract Law, do not respond to the external effects from the contractual relationship, but are concerned with the internal – to the parties – behaviours and effects. To what extent is in this context the goal of maximizing the joint welfare – contract surplus – of the parties affected by the issues of distribution of wealth that economists tend to recognise as relevant for normative reasoning?

My view is that it is mostly the third dimension of the relevance of distributive issues, which will be effective and important for substantive Contract Law rules, also, eventually, for European Contract Law rules. The level of wealth of an individual may, under a wide variety of circumstances, affect the incentives to act in one way or the other, and this influence has to be recognised by legal rules striving for social optimality. Thus, if A has to contract with B, on the one side, and with C, on the other, in order to obtain certain desired – entirely unsubstitutable, let's assume – results, it is likely that if C has assets much lower than B, the standard of performance may – optimally – be lower for C than for B. The reason for this is not a desire to give C more wealth than to B at the expense of A (who may be wealthier than both of them), but simply to maximize contractual effort by C and by B, given their exogenously given levels of assets. In fact, an optimal contract fully specified, between A and C would contain such a lower standard, compared with the complete, fully specified contract between A and B. The Law, as a default, when parties may be unable to draft a complete contract may well include this differentiated standard based on the relative level of assets of the contracting parties.<sup>30</sup> But the relevance of wealth and distribution in these circumstances does not respond to a redistributive policy or desire, simply to an improvement of behavioural incentives of the parties, as it happens, influenced here by those issues of distribution. In essence, we remain here in the safe terrain of efficiency, of providing the incentives that the parties themselves would have provided in a fully contingent and complete contract.

More problematic, at least with our current level of knowledge, is the first dimension, the one based on the presence of a specific taste for distributive concerns in the utility functions of the contracting parties. Although there seems to be evidence in experimental settings of behaviour consistent with a

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<sup>29</sup> For instance, Art 1305, 1306, Spanish Civil Code and § 817, German Civil Code. On such a disincentive vision of these rules, GOMEZ, GANUZA (2002, p. 475); WAGNER (2006, p. 365).

<sup>30</sup> This logic does not necessarily apply in all circumstances and contracts and, in fact, a default rule based on levels of wealth may be counterproductive under many other circumstances.

strong taste not to be treated in an obviously unequal fashion,<sup>31</sup> it seems very problematic to translate this taste into substantive obligational content in abstract Contract Law rules, or even in factors that may be fruitfully employed in such kind of legal rules. At the level of European Law, which would apply to a more diverse set of individuals and groups than a national legal system, this note of caution is particularly required, given that the available evidence points at large differences among cultures and societies in the experimental results.<sup>32</sup>

Also problematic, though for different reasons, would be to pursue through general Contract Law rules a policy of consistently redistributing welfare, or wealth more narrowly, from one contracting party in favour of the other, even if one thinks that the gains from trade and interaction between parties are unequally distributed (for instance, are systematically biased towards sellers and against buyers) and that the legal system should attempt to correct the imbalance in this distribution.

The problem with the use of substantive Contract Law rules to achieve this redistributionist policy, even accepting the premise of its overall desirability,<sup>33</sup> is that contracting parties, sellers and buyers, firms and consumers, affected by those rules are, by definition, in a contractual relationship. And this allows the parties to alter the terms of trade or the exchange. An increase in duties or rights that is not efficient or welfare-increasing, in the sense of augmenting the surplus of the interaction, will imply a readjustment of the terms to the detriment of buyers that cannot be compensated by the increased welfare of buyers due to a higher level of sellers' legal duties or buyers' legal rights. Thus, a purely redistributive legal intervention – one that does not increase joint welfare apart from how this welfare is shared among the parties to the interaction – is very likely to become moot due to the readjustment in price and/or other terms of the transaction, when the affected parties find themselves in a contractual situation.<sup>34</sup> As has been noticed already,<sup>35</sup> redistributive policies can be largely undone when the party benefiting – from redistribution – party and the losing party are not

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<sup>31</sup> See, for a theory of inequality aversion based on this evidence, FEHR, SCHMIDT (1999). Some think a reciprocity preference more explanatory: RABIN (1993).

<sup>32</sup> See CAMERER (2003, p. 68 and following).

<sup>33</sup> Many economists and economically-inclined lawyers are skeptical of the use of legal rules (outside the tax and social transfers rules) to redistribute wealth. The best presentation of this view, in KAPLOW, SHAVELL, (1994); KAPLOW, SHAVELL (2000). The core of the argument is as follows: The use of taxes and transfers as redistributive mechanisms just creates one distortion, namely in the work-leisure trade-off. Substantive legal rules generate a double distortion: One, the same we have just described for taxes, the other, the inefficiency generated by a legal rule chosen not on its efficiency merits, but on its redistributive effectiveness. Again, some within the Law and Economics literature disagree with this gloomy view of legal rules as redistributive instruments: C. JOLLS (2000); SANCHIRICO (2000); SANCHIRICO (2001). I do not take sides in this debate, because my topic here is narrower, as it refers solely to substantive Contract Law rules, and my view is that one can confidently answer the narrower question without attempting to answer the broader one.

<sup>34</sup> The argument is by no means a new one: See H. DEMSETZ (1972); HAMADA (1976); BEBCHUK (1980).

<sup>35</sup> See CRASWELL (1991). Emphasizing the difference in redistributive effectiveness between rules on bargaining starting points as opposed to rules on bargaining outcomes – ie substantive rights and duties in the contract –, see SANCHIRICO (2001, p. 1047).

into a contractual relationship. Thus, it is easier to redistribute with tort law rules than with contract rules, and among the latter, it is easier to redistribute through rules that allow one party not to enter into the contract, or alter the negotiation process, than through rules that govern, as mandatory or default provisions, the content of the relationship.

I will develop the argument with the help of figure 4 and figure 5, which provide an illustration of redistributive legal intervention favouring buyers.<sup>36</sup> In both, demand and supply for a given product or service is depicted. A mandatory contract legal right for the buyer (think of a non-waivable warranty on accompanying the product) is imposed. That the measure is pro-buyer is shown by the increase in demand following the introduction of the warranty:  $D2 > D1$ .

Figure 4 represents a legal right favouring buyers that does not increase contract surplus, because it costs the seller (as shown by the segment a-b, the distance between supply curve,  $S1$ , before the legal warranty is imposed, and supply curve,  $S2$ , after its imposition) more than it benefits the buyer (as shown by the segment c-d, the smaller distance from  $D1$  to  $D2$ ).

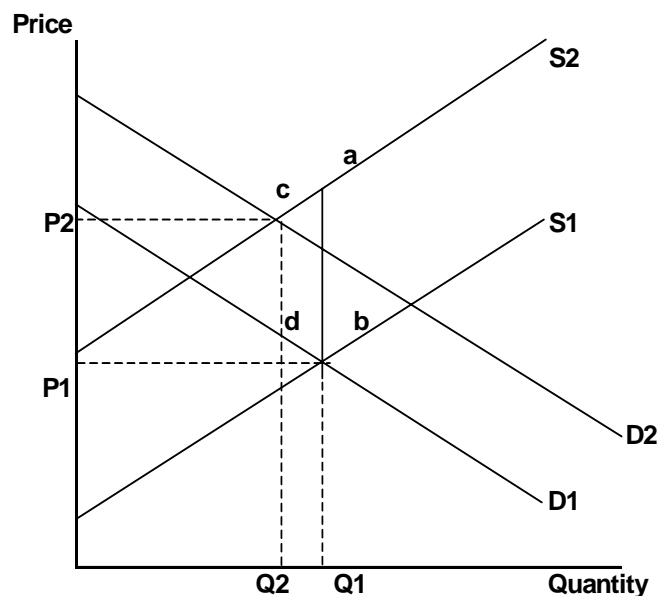


Figure 4

<sup>36</sup> To represent a redistributive policy pro-seller (of services, say, like the mandatory termination compensation in favor of the agent provided by Art 17-19, Dir 86/653) one would only need to reverse figure 4 and figure 5 (the inefficient legal intervention pro-buyer, as shown now in figure 4 would be an efficient legal intervention pro-seller, and vice-versa in figure 5).

After the pro-buyer legal measure is introduced, contract surplus, joint economic welfare, is reduced. But not only that, notice that buyers are actually hurt by the policy intended in their benefit. Some of them (those located between  $Q_1$  and  $Q_2$ , cease to contract, because they value the contract less than the new contract price  $P_2$ . And those who contract are also worse-off, because the difference in price ( $P_2 - P_1$ ) is more than  $c - d$ , the amount in which buyers value their new legal right. Notice that this worsening of the buyers' position is not due to excessive transfer of the costs of the new right from the sellers to the buyers. Sellers are also worse-off here, because the price increase ( $P_2 - P_1$ ) is less than the increased contract costs for the sellers ( $a - b$ ).

Figure 5, in turn, represents a legal right favouring buyers that does increase contract surplus, because it costs the seller (as shown by the segment  $c - d$ , the distance between supply curve,  $S_1$ , before the legal warranty is imposed, and supply curve,  $S_2$ , after its imposition) less than it benefits the buyer (as shown by the segment  $a - b$ , the larger distance from  $D_1$  to  $D_2$ ).

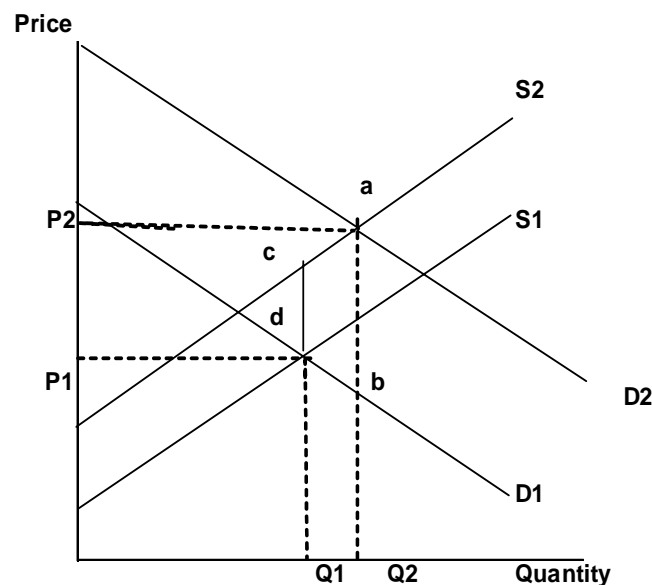


Figure 5

In this scenario, after the pro-buyer legal measure is introduced, contract surplus, joint economic welfare, is increased. But not only that, both sellers and buyers actually benefit from the imposed legal right. Of course the new buyers (those located between  $Q_1$  and  $Q_2$ ) are better-off compared with the no-contract situation. Those who were buyers before the legal change also improve their welfare because the increase in price ( $P_2 - P_1$ ) is smaller than  $a - b$ , the amount in which buyers value their new legal right. Notice that this improvement in the buyers' position occurs even if sellers are also benefiting from the change, because they are able to pass-on the increased contract costs ( $c - d$ ) more than proportionately:  $(P_2 - P_1) > (c - d)$ . Therefore, the distributive effects of contract rules does

not depend primarily on the ability of sellers to charge higher prices corresponding more or less to the higher costs produced by legal change.

Thus, if a pro-buyer legal rule is not joint welfare-enhancing, the readjustment of price and quantity terms will in the end reduce the well-being of the intended beneficiaries of the distributive policy. If the rule, on the contrary, increases contract surplus, even if sellers are benefiting, in net terms, from it, may as well have valuable distributive consequences favouring buyers. This implies, at least presumptively, a good case for Contract Law rules that create incentives for the behaviour of the contracting partners that maximizes the welfare of the parties affected by the contract.

The preceding analysis summarizes the outcome of distributive legal rules when buyers are homogeneous. When they differ in terms of the valuation of the increased duties or rights, the analysis is more complicated, and the result ambiguous, because there may be winners and losers among the group of buyers, thus raising distributive issues inside them. In fact, it is true, that under certain conditions, a pro-buyer legal rule that does not increase contract surplus may overall benefit the class of buyers. If the reduction in contracted quantity ( $Q_1$ - $Q_2$ ) is sufficiently small, and the valuation of the increased duties or rights by the marginal buyer is sufficiently smaller than the corresponding valuations of the infra-marginal buyers,<sup>37</sup> it is the case that even if the imposed rule is inefficient – it reduces joint surplus – buyers as a group – albeit not all of them – will be better-off at the expense of sellers, who would not be able to recover through the increase in price the entire impact on production or distribution costs of the pro-buyer rule.<sup>38</sup>

The qualitative implication, namely that inefficient legal intervention is not likely to be an attractive redistributive policy, however, still holds. First, because pro-buyer rules that reduce joint welfare of the contracting parties tend to burden more heavily the marginal buyers, and these are typically those who are more worthy of redistribution in their favour, and in turn, tend to favour more intensely the infra-marginal buyers, who are the ones that even before the legal change already enjoyed a higher share of the contract surplus. In other words, inefficient legal interventions are more likely to produce regressive internal redistribution among buyers. Second, because the requirements for effective redistribution through non-welfare enhancing rules are restrictive and exacting. This makes hard for the legal decision-maker in Contract Law (legislator or Court) to be in possession of the necessary information to make the right redistributive choice. If the required information is not available, the likelihood that with an inefficient rule we end up also with an undesirable distributive outcome is relatively high.

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<sup>37</sup> The marginal buyer is the one located along the demand curve at the equilibrium price. Infra-marginal consumers are those located up the demand curve. Marginal buyer's valuation is the one that determines the equilibrium price, which will be paid, however, in the same amount by all buyers – absent price discrimination.

<sup>38</sup> See R. CRASWELL (1991, p. 377 and following). Even those who are more sympathetic to redistributive policies among the economic analysts of the Law acknowledge the existence of these restrictive assumptions for an effective redistribution pro-buyer in the contractual context: See SANCHIRICO (2001, p. 1046).

All the preceding reasons cast substantial doubts on the ability of Contract Law Rules, and not the least those in European Law, to ambitiously pursue distributive objectives. Particularly when these seem to overtly conflict with maximizing the size of the welfare pie produced by the contract, the redistributive bent should be considered very cautiously, as it is likely that they will be will not be distributively appealing, in addition to being inefficient. This does not mean that wealth and its distribution should be entirely disregarded in the design and implementation of Contract Law rules, but essentially their role should be important when these dimensions improve the behavioural incentives that lead to greater total contract surplus, or joint economic welfare of the contracting parties.

#### *4. The Proper Scope of European Contract Law*

In this section I will tentatively venture on more dangerous terrain, namely advancing my own view of the optimal scope of European Contract Law. If one were to use the terminology popularized by our digital age, of the 4 possible areas of contract interaction, B2B, B2C, C2C, and C2B, European Contract Law, as envisioned in the Commission statements, and the scholarly initiatives under way, should not address nor cover all of them.

The traditional domain of European Contract Law rules has been B2C contracting. Legal intervention in B2C contracts is, however, largely and ostensibly a form of regulation of consumer markets for some specific economic sectors (defined in terms of the underlying good or service, or on some other ground). This regulation of consumer market imperfections can be enforced through the initiative of private parties (the individually affected consumers) or through the initiative of public agencies or bodies. In the first case, one typically speaks of private (Contract) Law, and in the second of public (regulatory) Law. The difference between both enforcement mechanisms, however, is pragmatic, and a question of the relative advantages of one or the other under certain circumstances, but does not refer to the substantive normative or behavioural content of the rules. In fact, probably the optimal legal solution would be a mix of both kinds of mechanisms, as we in fact observe in most European legal systems.

And consumer market regulation is centrally concerned, and rightly so, with a singular type of market failure: Lack of consumer information. The market mechanisms providing information to consumers, though numerous and powerful, undeniably are unable to achieve, in many circumstances and for many transactions in consumer markets an optimal level of consumer information. There is room, thus, for improvement in this inefficiently low level of information through legal rules apt at the correction of informational market failures.

These informational market failures arise out of a broad range of factors: First, some market participants might engage in fraudulent and deceptive practices, inducing inaccurate representations in consumers that cause distortions in their decisions and behaviour. Maybe due to the uncontroversial characterization of fraud, misrepresentation and deception as undesirable phenomena, the fact is that the role of consumer protection Law in deterring such inefficient market practices has not been fully appreciated. Probably the unscrupulous fly-by-night producer is the major source of consumers' misinformation and overall harm, and the efforts to deter this type of seller are among the most valuable in the whole enterprise of consumer protection policy. This may explain and justify the existence of regulations against unfair commercial practices, including advertising ([Directive 2005/29/EC of the European Parliament and of the Council of 11 May 2005 concerning unfair business-to-consumer commercial practices in the internal market](#)), as well as strict information and contract formation requirements in those consumers' markets and contractual practices more likely to have a high proportion of small and quickly exiting firms, such as door-to-door sales, distance sales, and electronic sales ([Council Directive 85/577/EEC of 20 December 1985 to protect the consumer in respect of contracts negotiated away from business premises](#); [Directive 97/7/EC of the European Parliament and of the Council of 20 May 1997 on the protection of consumers in respect of distance contracts](#); [Directive 2000/31/EC of the European Parliament and of the Council of 8 June 2000 on certain legal aspects of information society services, in particular electronic commerce, in the Internal Market](#)).

Consumers' lack of information can be the result of well documented phenomena in consumers' behaviour such as bounded rationality (limited capacity to acquire and process information),<sup>39 40</sup> over-optimism, use of cognitive heuristics (hindsight bias, excessive reliance on easily available data, excessive representativeness of small samples, too little weight of future and uncertain events, etc), and rational ignorance (if acquiring information is – even minimally – costly for the consumer, but having the information would not change neither the terms of the transaction nor future use, the consumer may rationally forgo the acquisition of information and prefer to remain ignorant on a relevant variable).

Consumers' ignorance due to all these factors is hard to ameliorate. Firms do have some incentive to educate and inform consumers so that those problems are less acute in many cases. But the market incentives for firms do not reach the level of the socially appropriate incentives to educate and inform consumers. Regulation can, to some extent, provide partial remedy in some contexts, particularly through disclosure requirements and the creation and imposition of a standardized system of measuring and expressing one or more of the variables relevant to the transaction. Mandatory and standardized labelling and information disclosure are also common concerning

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<sup>39</sup> See EISENBERG (1998, vol. I, p. 282); SUNSTEIN (2000).

<sup>40</sup> Moreover, bounded rationality makes the appeal of deceptive and misleading advertising higher for some producers: See NAGLER (1993). And surveys of advertisers show that legal constraints are the most important factor influencing decision-making about advertising content and policy: J. DAVIS (1994).



health and safety factors, and experimental and empirical studies have shown them to have had a positive impact on welfare-enhancing consumer choices in the relevant markets.<sup>41</sup> Additionally, cooling-off periods allowing the consumer to cancel the transaction during a limited period after it was agreed can be understood as a way of reducing the impact of bounded rationality and cognitive deficiencies in those consumer transactions in which these problems might seem more serious (Directive 85/577/EEC; Directive 94/47/EC of the European Parliament and of the Council of 26 October 1994 on the protection of purchasers in respect of certain aspects of contracts relating to the purchase of the right to use immovable properties on a timeshare basis; Directive 97/7/EC of the European Parliament and of the Council of 20 May 1997 on the protection of consumers in respect of distance contracts)<sup>42</sup>.

The centrality of the informational market failures in consumer markets should not induce us to think that the imperfect information rationale sets an insurmountable boundary to the kind of rules that an optimal regulation of consumer markets may use. In particular, the regulatory toolkit is not restricted to information-enhancing measures, but also disclosure and standardization requirements, and prevention of deception and fraud. Additionally, the characteristics of some informational problems may (but only 'may') suggest that mandatory regulation of some substantive issues in the transaction may be the best cure for such informational market failures.<sup>43</sup>

The preceding ideas suggest that the task of consumer protection legislation, be it at the national or at the European level, is essentially a regulatory endeavour, aimed at correcting the informational market failures that may afflict consumer markets in different sectors and in different areas. Whether to emphasize sector-specific regulatory measures, or to rely more heavily in non-sector specific rules and principles is an important matter of regulatory strategy,<sup>44</sup> but does not undermine the conceptual regulatory nature of the enterprise.

When one turns to B2B interactions, we are in a different scenario. Here, the task of legal rules seems, at least to me, far away from market-correcting regulation trying to ameliorate the level of information of may be unsophisticated, and in any case frequently uninformed consumers. Here the transacting parties are – typically, in any case – repeat players, sophisticated agents pursuing, unabashedly, their self-interest. Although informational asymmetries cannot be ruled out entirely,

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<sup>41</sup> MOORMAN (1996); MATHIOS (2000).

<sup>42</sup> REKAITI, VAN DEN BERGH (2000, p. 374 and following, 385 and following), argue that cooling-off periods, particularly those introduced by EC consumer protection legislation, are potential remedies for irrational behavior, situational monopoly and informational asymmetries. Some, however, doubt the effective impact of those measures, the reason lying in the prediction that few consumers would exercise a right of cancellation that requires them to admit to themselves that they acted as suckers by signing the contract in the first place: See RAMSAY (1998, vol. 1, p. 412). Others do not only consider them irrelevant, but criticize those provisions as important sources of *ex-post* opportunism by consumers: H. SCHWINTOWSKI (2001, p. 341-346).

<sup>43</sup> See, for a more detailed analysis, GOMEZ (2003, p. 187).

<sup>44</sup> See GOMEZ (2006).

there is little room here for the structural regulatory measures that legal systems apply to consumer markets.

The role of legal rules (of Contract Law rules, to be more precise) is in this context of contracting between firms more modest and limited, which not necessarily means easier to accomplish: To facilitate that contracting parties undertake the actions and decisions that maximize contract surplus. This is most naturally implemented through non-mandatory or default rules, which offer solutions in line with those that a fully contingent, complete contract between the parties would have foreseen and specified.<sup>45</sup> The optional instrument to which the Commission Communication on the action plan for a more coherent Contract Law makes explicit reference seems to nicely fit into this role. It is also in this function that legal rules envisioned at the European level can make more significant contributions to promoting economic welfare.<sup>46</sup> Although it may seem narrow in scope, and far from the spotlights and political visibility of major policy initiatives, the rather obscure and technical task of crafting efficient default rules for B2B transactions – within a set of rules and principles that is, in itself, also an added option to facilitate efficient contracting – is, in my view, the role that European Contract Law can most aptly perform.

As for C2B and C2C exchanges, for various reasons I also think there are strong reasons not to be too much concerned from the point of view of European Contract Law. As for the first, because by far the most relevant, theoretically and empirically, of such transactions, is the contract of employment, and this relationship, for a diverse set of historical, sociological, political, and economic reasons, is subject in all EU Member States to a separate sort of market regulation.

As for the second, though I do not pretend to have data on this point, my guess is that, again by far, the major source of such C2C transactions in any modern economy is real property sale and lease. In this area, I do not see that European Contract Law can make a difference with respect to the long-established, and widely known and internalized in each jurisdiction, set of rules concerning the sale and lease of real property. This should not be taken as meaning that no cross-influences, or inspirations, can be drawn from this area into the B2B setting of European Contract Law, and vice-versa, but institutionally, it seems clear to me that both areas should be kept separate.

## 5. Conclusions

This paper has tried to bring together a quite diverse set of ideas and concerns about European Contract Law, all of them from a Law and Economics perspective. The present enterprise of designing and making politically feasible a set of pan-European rules in Contract Law requires, in my view, more ambitious goals than introducing technical improvements in the *acquis*, and paving

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<sup>45</sup> See, with very similar proposals, SCHWARTZ, SCOTT (2003).

<sup>46</sup> For a defense of the economic advantages of such an optional scheme, see GRUNDMANN, KERBER (2006).

more smoothly the way for the internal market. Contract Law needs theoretically coherent goals, and economic analysis seems, at least to me, a promising place to look at in search for them. Inducing cooperation in economic exchange outside perfect markets – that is, relationships in which time, and the contracting partner does matter –, and maximizing the joint welfare of the contracting parties seem appealing normative guidelines, however abstract or broad they may be, for Contract Law. Although issues regarding distribution of wealth do have importance for the substantive content of Contract Law rules, economic thinking tends to be more sceptical than most academic lawyers are, concerning the ability of Contract Law to bring about desirable outcomes linked to clear wealth redistributive policies. As the particular endeavour of European Contract Law goes, in the paper a more modest scope that hinges upon inter-firm transactions is tentatively defended as more adapted to the goals and functions that a set of substantive Contract Law rules can more aptly deliver, although keeping in mind the nature of consumer protection legislation as a regulatory framework essentially centred around the correction of informational market failures in consumer markets.

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